

Module 5: Financial Markets

USAID Economic Growth Officers
Training Workshop - Financial Sector



Agenda

1. Bank-based and market-based financial systems
2. Non-Bank Financial Intermediation
3. Challenges for Financial Markets Activities in Developing Countries
4. Global Trends in Financial Markets – Impact on Developing Countries
5. USAID Assistance in Financial Markets

Financial Instruments: Debt and Equity

- DEBT financing– contractual obligation to repay corporate borrowing
- EQUITY financing – sale of shares that represent non-contractual claims to the residual cash flow of the firm

Bank-Based and Market-Based Financial Systems

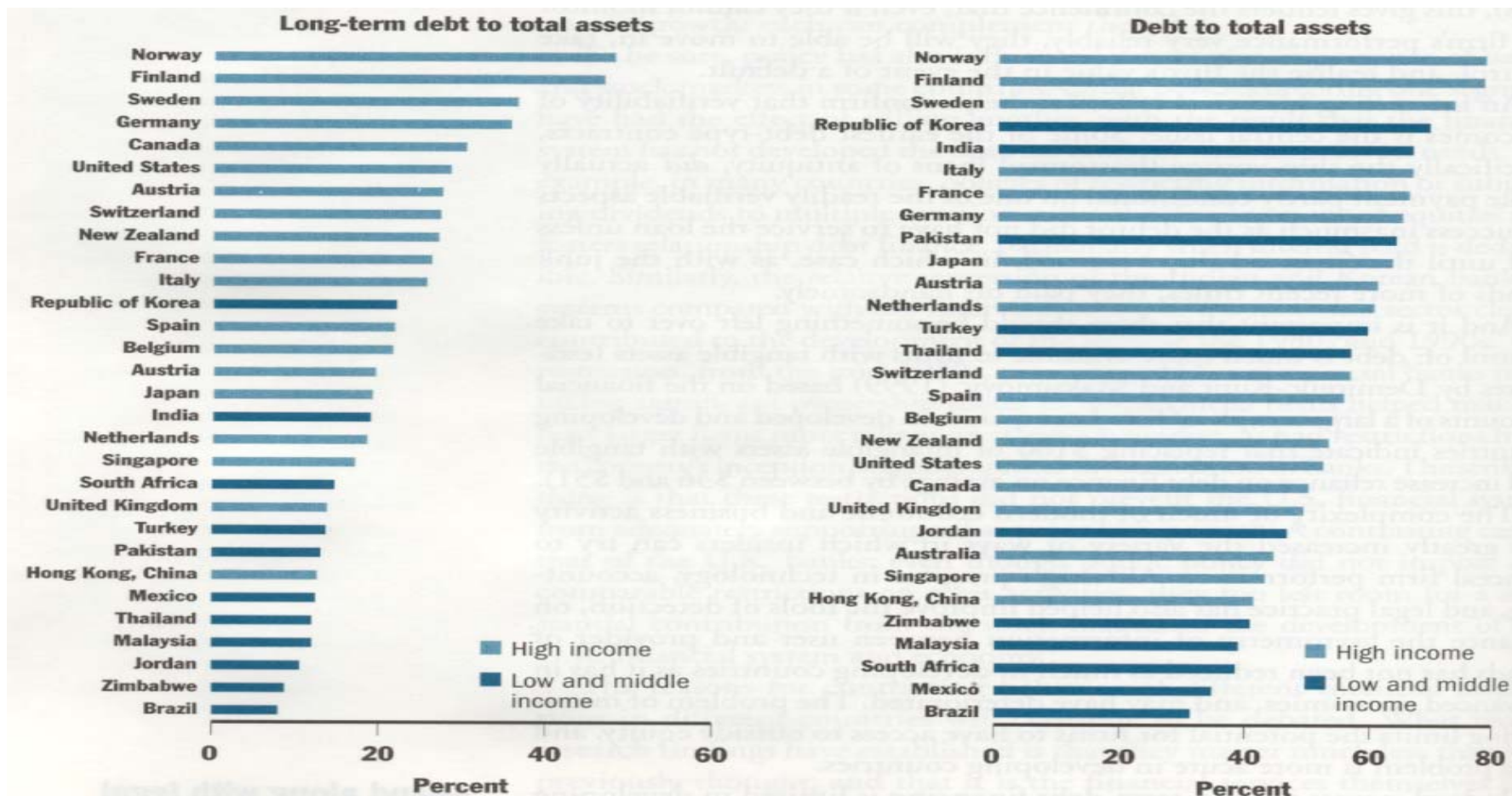
Bank-Based System Models: Germany, Japan

- Banks are knowledgeable investors; also long term due to exit limits
- When legal, accounting and regulatory systems are weak, powerful banks can obtain information and enforce debt contracts
- Limits for developing countries since credit not readily available

Market-Based System Models: US, UK

- Provide conditions for risk diversification and customization
- Relies on high-quality information and protection of shareholders
- Investors need not be knowledgeable, can be short-term oriented due to ease of exit
- Countries can be market-based due to poor banking sector (Mexico, Turkey)

Average leverage of listed firms in industrial and developing economies



Note: Data is for the average of information collected 1981–90.

Source: Based on Demirgüç-Kunt and Maksimovic (1999).

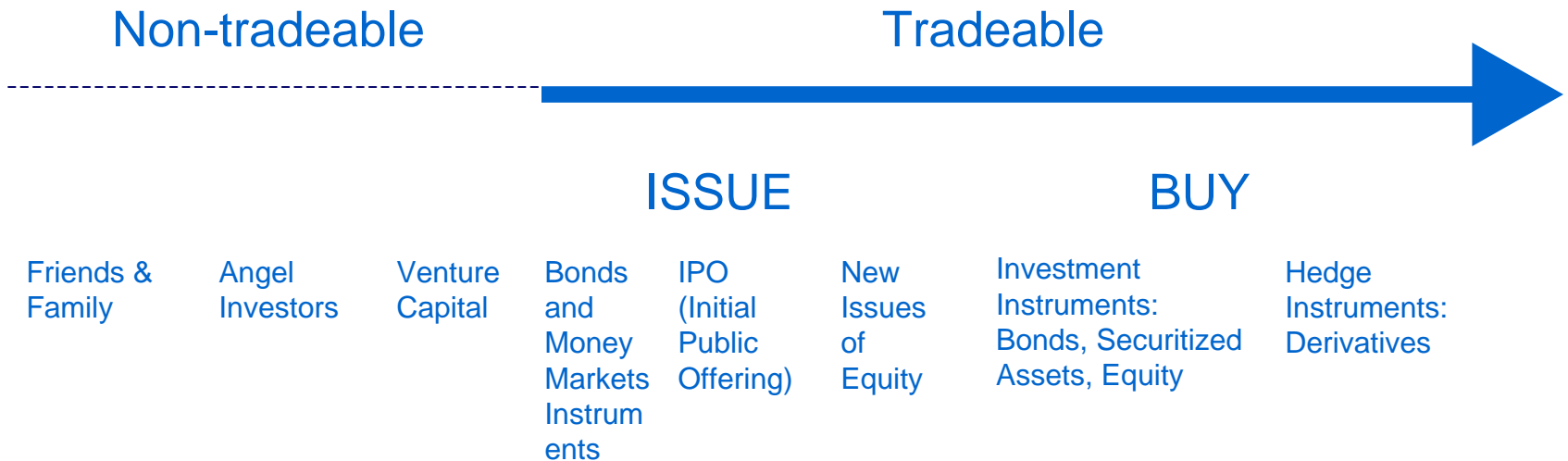
Source: World Bank, 2001, *Finance For Growth*, Washington, D.C., pag. 50.

Bank-Based and Market-Based Financial Systems

- In general debt is more available to firms with tangible assets
- Information asymmetry and weak regulatory environments limit access to equity in developing countries
- Access to long term debt limited in developing countries due to poor collateral laws and weak judicial system
- Bank financing in developing countries is expensive (spreads up to 8%)
- Firms in developing countries use as main sources of financing retained earnings and equity funding from insiders – development hurdle
- Equity markets and banking finance complement each other and compete

Continuum of Financial Instruments for Businesses

Tradeable Debt and Equity



Continuum of Financial Instruments for Individuals

Tradeable Debt and Equity



Money
Markets
Instruments

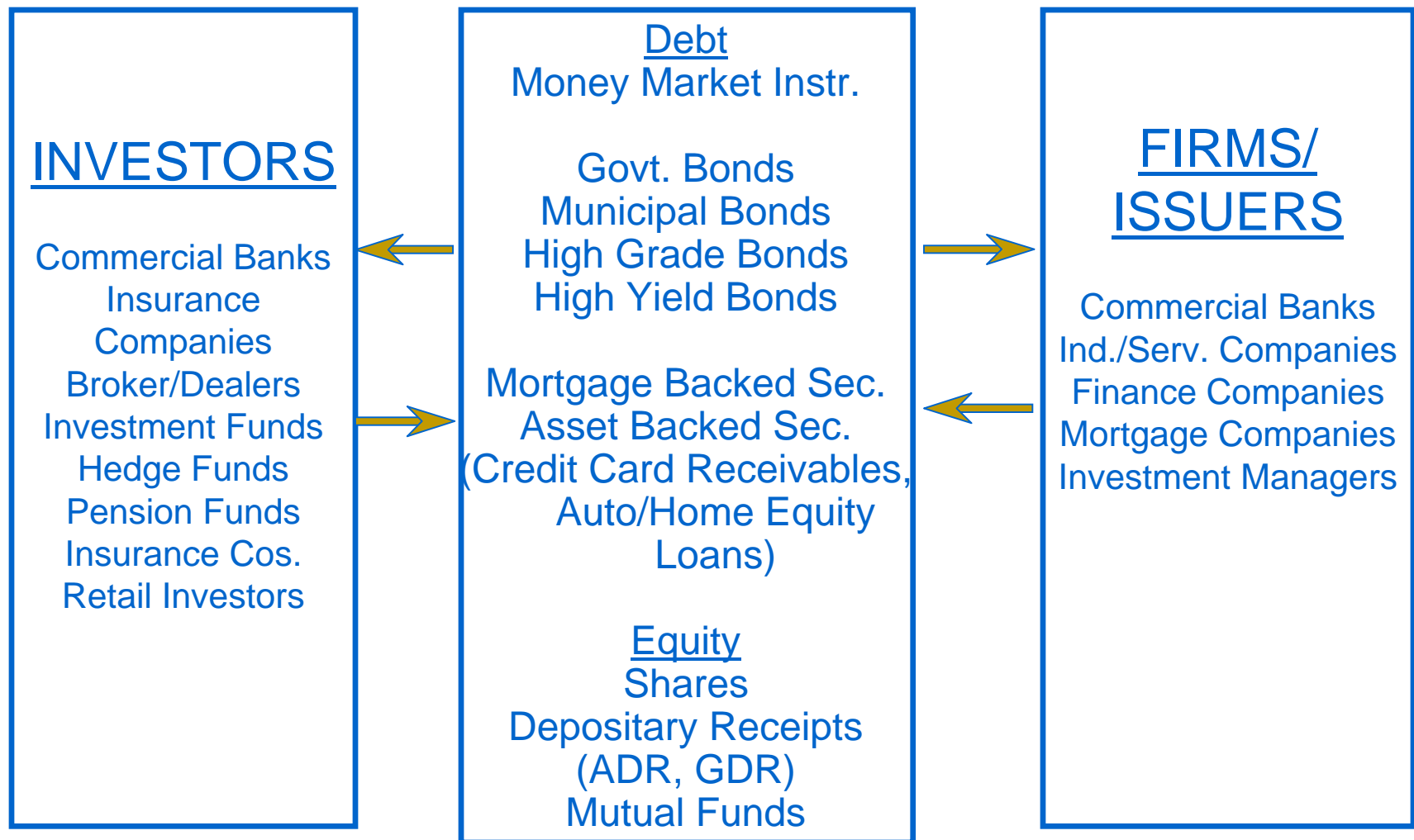
Investment Funds:
Bond/Income Funds,
Equity Funds, Mixed

Individual
stocks and
bonds

Pension Funds
Investments

Hedge
Funds
(high net worth
individuals)

Fin. Markets: Investors, Products, Issuers



Money and Capital Markets

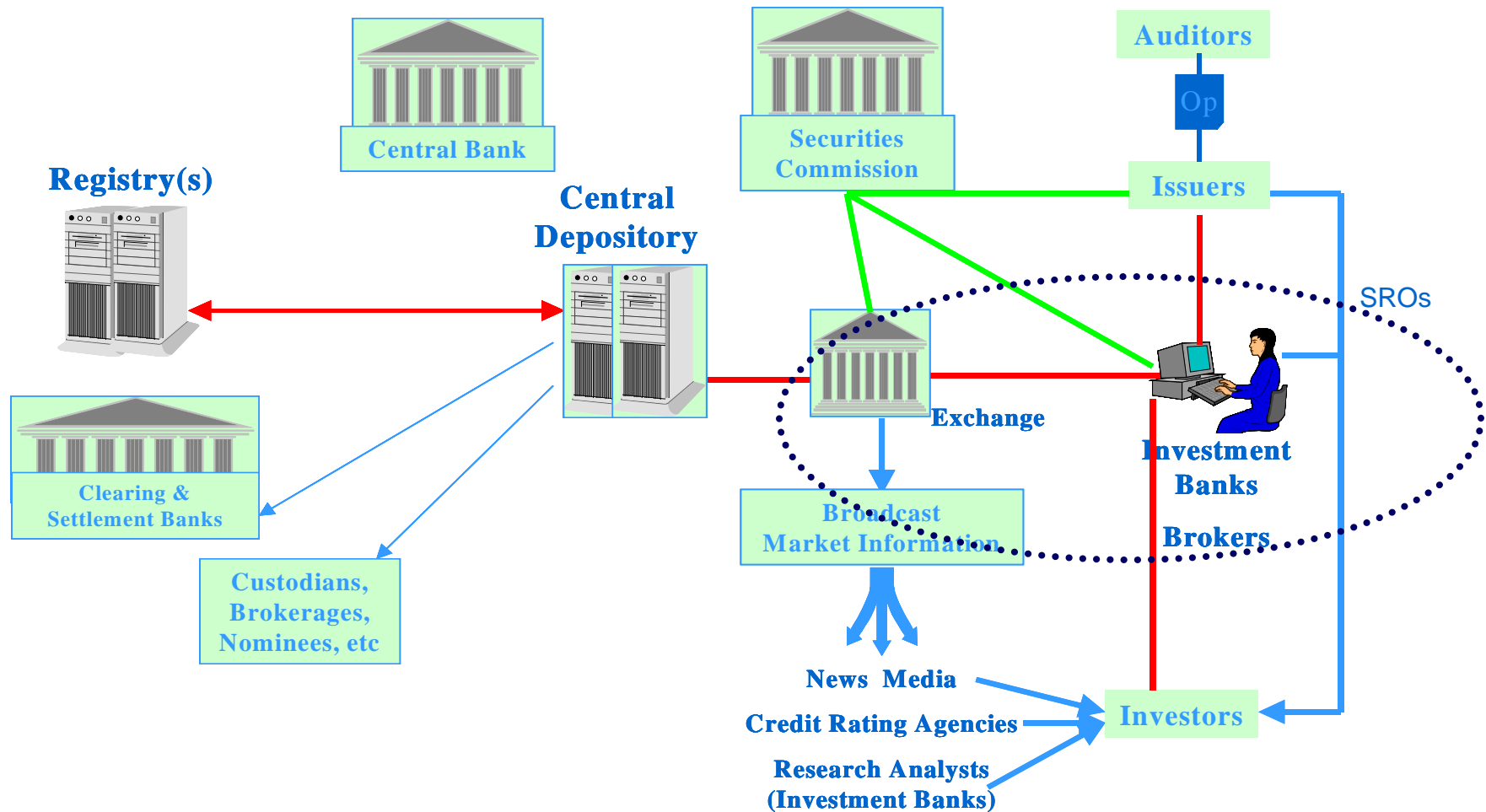
Financial Markets are composed of:

- Money Markets: markets for debt securities that pay off in the short term (usually less than one year)
 - Loosely connected dealer markets (dealers buy and sell instruments for their own inventory)
 - Core of money markets: large banks, govt. securities dealers, commercial paper dealers, money brokers
- Capital Markets: markets for long-term debt and for equity shares

Primary and Secondary Markets

- Primary Market: initial sale of newly issued securities
 - Underwriting syndicate, registration of issue
 - Public offering vs. private placement
- Secondary Markets: trading of securities after their original sale
 - Dealer markets (most debt securities) – over-the-counter (OTC) market
 - Exchange markets

Exchange-Based Capital Market



Non-Bank-Financial-Intermediaries (NBFIs):

- Financial Services Providers: specialized securities brokers, mortgage brokers, management consultants, investment advisers
- Specialized Sectoral Financiers: general, real estate, leasing
- Market Makers: dealers (equities, government and corporate bonds, derivatives)
- Collective Investment Vehicles (Contractual Savings Institutions): mutual funds and pension funds
- Insurance (Risk Pooling Institutions): general and life insurance

Role of NBFIs

- Help allocate risk and resources
- Provide alternative intermediation
- Provide market depth and liquidity
- Provide diversification to investors
- Provide savings mobilization vehicles

Regulation of NBFIs

- Regulatory Objectives
 - Protect the Investor
 - Guard against: Anticompetitive Behavior, Market Misconduct, Information Asymmetry, Systemic Instability
- Regulatory Structure
 - Functional vs. Institutional Regulator
 - Integrated Regulator
- Regulatory Backing
 - Political Support and Legislative Powers
 - Funding, Skill Base
 - Review: Competitive Neutrality, Cost-Effectiveness, Transparency, Flexibility, Accountability

Source: Carmichael, Jeffrey, Pomerleano, Michael, 2002, *"The Development and Regulation of Non-Bank Financial Institutions"*, World Bank, Washington DC.

Regulation of NBFIs

- Regulatory Implementation
 - Entry Requirements
 - Ongoing Requirements (Disclosure, Gov. and Fiduciary Duties, Anticollusion Rules, etc.)
 - Surveillance (Complaints, Monitoring, Inspections)
 - Enforcement (Prosecution, Preemptive Resolution)
 - Incentives
 - Delegation of Responsibilities – SROs

Who Sets the Standards for Financial Markets?

- International Organization of Securities Commissions (IOSCO)
 - Legislative and Regulatory Framework
- International Securities Services Association (ISSA), G30
 - Clearing, settlement and depository functions
- International Federation of Stock Exchanges (IFSE)
 - Vision for future development, trading standards
- U.S Securities and Exchange Commission (SEC)
 - Provides advice to commissions around the world
- International Accounting Standards Board (IASB)
 - Independent, privately funded – sets the IAS – now ISFR

These Standards Drive How Investors and the International Community will View a Market

Challenges Faced by Developing Markets

- Trust
- Small markets, small size companies, low volumes of financial transactions
- Disincentives for public companies – high costs, no clear benefits
- Dominance of private transactions
- Low liquidity and few products
- High transaction costs
- Lack of regulatory transparency and enforcement
- Low information efficiency--weak disclosure and little dissemination
- Weakness of institutional investors to push corporate governance
- Low public (retail) participation level
- Capital flight
- Sustainability of stock exchanges and brokers uncertain

5 Key Trends Influencing Financial Sectors Internationally (USAID-DTT Financial Sector Forum)

1. Globalization, Consolidation, and Convergence of Intermediaries and Markets
2. Information Disclosure and Governance
3. E-Finance –and Technology
4. Safety Net Reform
5. New Financial Products

Global Trends and How They Affect Developing Markets

- Liberalization of cross border investment flows
 - Regulatory challenge, competition for capital and for customers, higher standards, capital outflows
- Consolidation of financial services firms
 - Regulatory challenge, competitive challenge for domestic financial intermediaries, higher standards
- Expansion of financial instruments (securitization, derivatives)
 - Regulatory challenge, risk management issues
- Harmonization of disclosure (GAAP, IAS – now ISFR - requirements)
 - Regulatory challenge, pressure to implement higher standards
- Active corporate governance
 - Regulatory challenge, pressure to implement higher standards, to change regulations and practices

Why Should USAID/Donors be Involved?

- Support Economic Growth
 - Ensure financial self-sufficiency for emerging economies (reduce dependency on international financing, strengthen NBFIs)
 - Enable increase in domestic consumption (mortgages, auto loans)
 - Create conditions for pension reform – availability of non-government investment products
- Drive reform of business environment: corporate governance, transparency, anticorruption, anti-money laundering
- Avoid manipulation of financial markets by powerful parties

Why Not Let the Private Sector Develop the Financial Markets?

- Asymmetry of knowledge and market power among players (financial services companies, government agencies, etc.)
 - Gravity of risks associated with failures (e.g. pyramid schemes in Albania)
 - CDIE argues that “capital markets developed by the private sector alone will not produce the most satisfactory development result” in two main areas:
 - Protection of investors from firms
 - Protection of investors and firms from stock market intermediaries
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- CDIE USAID, “Efficient Capital Markets: A Key to Development” Program and Operations Assessment Report No. 26, November 2000, p. 16.

Scope of USAID Assistance in Capital Markets – “Early Stages” Markets

Armenia and Macedonia Projects

- Legal reform
 - Develop securities market legislation
- Regulatory capacity
 - Develop regulations
 - Build institutional capacity, training
- Trading platforms and clearance and settlement systems
 - Establish Stock Exchange (incl. technological infrastructure)
 - Establish C&S Infrastructure
- Self Regulatory Organizations
 - Assistance to SRO formation and capacity building

Scope of USAID Assistance – “Later Stages” Markets

Philippines – USAID AGILE project

- Assistance to the regulator – enforcement, training
- SRO – Assist in the establishment of a new Fixed Income Exchange
- NBFIs – pointing out pre-need’s weaknesses – at high risk

India – USAID FIRE project

- Assistance to the regulator – surveillance, restructuring and training, STP and T+1 issues
- SRO – support to various entities
- Establishing securities market law programs at institutions of higher education

Where Has USAID Succeeded ?

- USAID has succeeded in achieving many of its outputs and intermediate outcomes:
 - Building systems infrastructure
 - Improving regulatory environment
 - Improving supervisory and regulatory capacity

Where Has USAID Not Succeeded ?

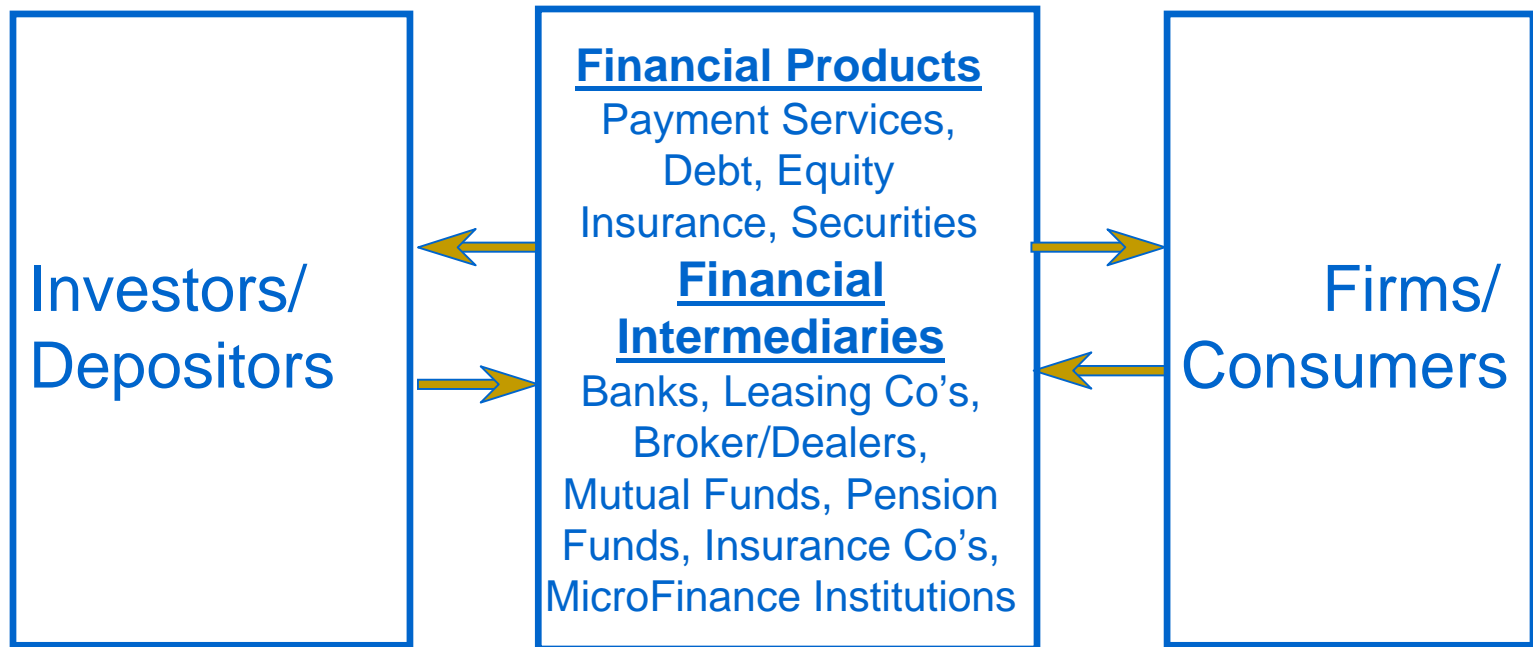
- Often failed to achieve desired final outcomes:
 - Developing markets from scratch
 - Generating liquidity
 - Creating measurably better allocation of capital
 - Reducing transaction costs
 - Creating market discipline for large enterprise
- Rarely a focus on non-bank financial intermediaries
- Wrong Assumptions (in hindsight...)
 - Infrastructure=Volume; “If you build it; they will come”
“Building” driven by mass privatization
 - Creating wide ownership will create market discipline

Financial Market Reform Going Forward: Approach/Sequencing Reforms

- Build regulatory framework
 - Build/strengthen Regulators
 - Assist in the establishment of effective SROs
- Help develop industry skills (“early stages” markets)
- Implement international standards and best practices
- Coordination with WB/ADB/IADB for policy/conditionalities and with IFC and EBRD for direct financing of capital for private sector initiatives

What is An Integrated Approach ?

- Examining and targeting all stakeholders and institutions



Market Facilitators: Central Banks, Regulators, Credit Bureaus, Professional Services Providers, Stock Markets, Depositories

Why Does An Integrated Approach Work ?

- Addresses the continuum between:
 - Banks and other service & debt providers
 - Financial markets
 - Non-bank financial intermediaries
- Provides assistance along the full range of market failures across the sector
- Looks at linkages to corporate governance, LIR, and market development
- Acknowledges creative “pump priming” is needed in many markets in conjunction with support for regulatory framework

Factors for Deciding Appropriate USAID program for each country (USAID-DTT Financial Sector Forum)

1. The USAID budget as compared to the size and type of technical assistance required
2. What other donors are doing
3. USAID's ability to influence financial sector policy makers
4. US foreign policy objectives
5. USAID's current level of competence in the country and technical area
6. The political, economic, social and legal/regulatory characteristics of the country and the circumstances of the development of its financial sector

Financial Market Reform Going Forward: Integrated Interventions/Projects – to include

- Strengthen the Regulators' capabilities
- Assistance to Intermediaries
 - To increase level of professionalism – “early stages” markets
 - To develop effective SROs (training, certification, international standards)
- Corporate governance
- Drive reform of business environment: transparency, anticorruption, anti-money laundering
- Implement pension and insurance reform
 - Help build regulatory framework and regulators
 - Help develop industry skills – “early stages” markets

Project mix dictated by:

- Country level of development and political situation
- Existence and jurisdiction of local champions

What Are Some Promising Projects?

- Integrated financial sector reform in Macedonia
 - Integrating banking, capital markets, insurance and other assistance
- Creating liquidity through NBFIs assistance in Armenia – “NBFIs Incubator”
 - “Priming the pump” in a weak economy
- Creating a financial services cluster (and sub-clusters) using a competitiveness framework in Bosnia

Conclusions

- Financial market development promotes growth
- Donors have a role to help correct market failures—developing markets alone do not achieve adequate investor protection
- Financial market reform is not a leading edge reform -- it should be addressed in an integrated approach with other reforms
- Main focus of financial sector interventions should be the development of a proper regulatory framework
- Integrated projects should be designed with optimal mix of components dictated by the country specifics

Recommended Readings:

World Bank, 2001, *Finance For Growth*, Washington, D.C.

Carmichael, Jeffrey, Pomerleano, Michael, 2002, *“The Development and Regulation of Non-Bank Financial Institutions”*, World Bank, Washington DC.

World Bank, 2002, *Building Trust. Developing the Russian Financial Sector*, Washington, DC.

Constantin Abarbieritei

Director, IBM Business Consulting Services, Washington, D.C.

Email address: constantin.abarbieritei@us.ibm.com